Guest Editorial

Empowering democracy in corporate governance by unbundling shareholders' voting rights from their return on investment rights

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Normally, corporate ownership carries two types of rewards: monetary return on investment rights and a modicum of participation in governance. The former gives shareholders residual rights to returns on their investments, the latter bestows them some say in governance and indirectly in management. When return on investment rights and control rights are inseparably bundled, as they mostly are now, the vast majority of shareholders are too small, too diversified, and often non-conversant with financial matters to be able or willing to exercise meaningful control over the governance and management of the companies that they own. For the relatively few who are interested in control, the costs of forming and sustaining coherent and stable coalitions are usually too high. This state of affairs holds for most institutional investors as well. Hence, the presumption that shareholders, as individuals or groups, have a consequential say in the affairs of the public enterprises they own is viewed by many as largely fictitious.

Participatory governance is essential for a plausible form of shareholders' democracy to thrive. Investors need to know that they can have some significant inputs capable of affecting the way that their enterprises are run, of ascertaining that managers and boards are accountable, and of rendering them effectively replaceable. Without these fundamental checks and balances, incidences of incompetence and abuse, many of which are undetected or belatedly exposed, will

increase, dangerously compromising investors' confidence in the integrity and competency of the private business leaders. To a degree, this confidence has already been undermined by numerous financial and accounting scandals (eg Enron and WorldCom), many allegations of excessive executive compensation levels that are seemingly unrelated to performance, perceived lack of independence and conflicts of interest in auditing, acknowledged widespread failures in risk management in the financial sector, and protracted hostile struggles for corporate control. The cumulative effect of these spreading irregularities is likely to lead to higher costs of equity and debt, which are bound to restrict growth and productivity.

To enhance participatory governance by shareholders, we propose, in this editorial, the full unbundling of return on investment rights from voting rights. Such complete unbundling would be accomplished by issuing separate shares with voting rights only, and separate shares with return on investment rights only. This way investors will be given a clear choice. They could purchase earning rights only, control rights only, or both.

Shares with voting rights only will give shareholders, who are interested in control, stronger opportunities to affect management or to replace incumbent managers. Voting rights, in the same way as any other asset, will be priced by the forces of supply and demand. People who are interested in bidding for control of

the enterprise would drive the demand as they would be inclined to opt for the most effective path to compete for control. Predicting the unique dynamics of supply and demand of a system that currently does not exist would be highly speculative. Return on investment shares will not be akin to bonds, since they would not carry the contractual obligation to pay interest and repay principal. It is difficult to predict in advance how the price of return on investment shares will be affected by the price of voting shares. As return on investment rights are decoupled from voting rights, accumulating a significant stake of voting-only shares by individuals or coalitions would be easier to achieve, thereby presenting potent alternatives to seating managements. This competitive thrust should make functioning managers more alert, sensitive, and accountable, as well as more replaceable. Incentives to reign in incompetence, lessen complacency, reduce inefficiencies, and restrict opportunism, patterns of behaviour to which even reasonably well run enterprises are not immune, would be strengthened.

All shareholders stand to benefit when incumbent managements and boards are truly and vigorously challengeable. The potency of such challenges can be greatly enhanced by unbundling return on investment rights from voting rights. At present, only a very small minority of corporations issue two classes of common stock: shares with return on investment rights and voting rights, alongside shares with return on investment rights but with reduced voting rights. While the latter shares technically look as if they are unbundled (or at least partially so), they are actually a tool often used by founding families to guarantee long-term control over their companies. For example, the Bancroft family, prior to the recent takeover of the their company by News Corp., maintained their control over the Dow Jones Company for 105 years by issuing a special class of stock. That special class was designated as Class B shares with ten votes per share, while Class A shares — actively traded on the New York Stock Exchange — carried only one vote

per share. Under Dow Jones rules, when Class B shares were sold they became Class A shares and lost their special voting rights. This of course increased the relative weight of the remaining Class B shares. So much to be said for democracy in corporate governance.

For our proposed unbundling system to work effectively, the votes-only shares would have to be structured so as to decrease the likelihood of entrenched control. To that end, the votes-only shares would have to be leased by the corporation for limited periods. All voting rights inherent in those shares would expire at the end of the leasing period. Immediately after expiration, entirely new voting-only shares would have to be offered for lease in an open auction, thus forcing the incumbent majority holders to compete in the marketplace against new bidders for control. This limited period leasing, followed by expiration and prompt competitive reissue, is essential to prevent one group of managers from clinging to the helm and perpetuating their rule by refusing to sell any portion of the vote-only shares they own. The leasing periods for the vote-only shares would be made long enough to allow management sufficient time for effective strategic planning and implementation. During the leasing periods, the voting-only shares would be tradable, allowing the balance of control to be subject to constant change, if so desired by sellers and buyers.

The unbundling of voting rights and return on investment rights will give investors a much clearer and more effective choice. They could bid for control only, or opt for return on investment only, or strive for both at any ratio they wish. Managements and boards of directors will be driven to be more effective and accountable because they are constantly vulnerable to being deposed by investors who believe that they, or the managers they hire, can do better. The incidence of hostile takeover battles, with their frequent inefficiencies, would be significantly reduced. These contests would likely be replaced with a more orderly democratic corporate governance process of change in the groups who control our public corporations. Such changes

would help in retaining effective directors and managers, while easily replacing those who do not measure up.

Unbundling voting rights from return on investment rights could also attenuate opportunistic behaviour by managers and directors. Currently, senior managers can easily avail themselves of excessive compensation at the expense of shareholders. They can also manipulate the board of directors to limit shareholders' democracy by perpetuating their control over the corporation. Such abuses are likely to be attenuated, restricted, or even rectified, by unbundling voting rights from return on investment rights.

There would be always a looming danger that some groups of vote-only shareholders would bid for control over companies mainly to loot the return to investment shareholders. But there is very little under the current regime that prevents incumbent managers and directors from doing the same. Arguably, excessive executive compensation can be considered as a form of looting. With voting-only shares in play, unscrupulous investors, if they take over a firm, will likely be replaced more readily and more rapidly by 'corporate raiders' (such as Carl Icahn) who will be waiting in the wings, thus containing the damage. Additionally, we wish to emphasise that our proposal is fully consistent and can be combined with other ideas that aim to improve the state of corporate governance. One such idea is to create a new class of shares that will offer investors protection from opportunistic behaviour by managers by requiring the issuing companies to pay the holders of this special class of shares a pre-specified cash dividend whenever executive compensation level exceed a pre-determined level of 'basic' executive compensation.¹

NOTE TO READERS

The special issue on India, scheduled for this issue has been postponed to the next issue due to the illness of one of the editors. Our apologies for this delay. We are also pleased to announce that the 2008 *International Journal of Disclosure and Governance* conference will be

held jointly with the 2nd World Continuous Reporting Conference at Rutgers Business School on Friday, 9th May, 2008, sponsored by Grant Thornton LLP and the Rutgers Continuous Assurance and Reporting Laboratory. Building on the success of the inaugural IJDG Conference and the 1st Continuous Reporting Conference, both held in 2007 at Rutgers University, the joint 2008 conference examines important changes that are taking place in the global financial reporting environment. These include:

1. The increasing demand and development of enabling technologies for continuous reporting.
2. The likely imminent mandatory use of what SEC chairman Christopher Cox calls 'interactive reporting', particularly the Extensible Business Reporting (XBRL) methodology.
3. The continuing work of the Enhanced Business Reporting Consortium to create a more transparent corporate reporting system.
4. The FASB's decision to radically change the income statement, balance sheet, and cash flow statement by requiring subtotals for five general categories: business, discontinued operations, financing, income taxes, and equity.
5. The liquidity crisis brought on by the subprime mortgage debacle and the questions it raises about the adequacy of measurement and reporting of risk and exposure.

These and other profound questions concerning the future shape and direction of financial reporting will be discussed by leading regulators, accountants, academics, and users including representatives of the SEC, FASB, IMA, AICPA, FEI, and analysts.

All those interested in participating should contact Professor Miklos Vasarhelyi at miklosv@andromeda.rutgers.edu. Submissions are invited of papers to be presented, or topics for panel discussions. All presentations at the conference will be considered for publication in a special issue of the *International Journal of Disclosure and Governance*.

For more information please see the conference website: <http://raw.rutgers.edu/2ndcsrc/index.htm>.

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REFERENCE

- 1 Palmon, D. and Sudit, F. (2007) 'Shareholders' defensive security shares', *International Journal of Disclosure and Governance*, **4**(3), 195–203.